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By Hand Delivery

Magalie Roman Salas
Office *of* the Secretary
Federal Communications Commission
445 Twelfth, S.W., Room TW-B204
Washington, DC 20554

Re: Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92

Dear Ms. Salas:

Enclosed please find AT&T's Comments in the above captioned proceeding.

Respectfully yours,

David L. Lawson

:pab:pb

Enclosure

cc: Paul Moon
Jane Jackson
ITS

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Developing a Unified Intercarrier Compensation Regime	)	CC Docket No. 01-92
	)	

<u>COMMENTS OF AT&T CORP.</u>

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August 21,2001

EXECUTIVE SUMMARY

AT&T strongly endorses the Commission's goal of reforming and unifying legacy intercarrier compensation regulations. As the *Notice* recognizes (¶¶ 1-2), the existing patchwork of intercarrier compensation rules is wholly incompatible with the Telecommunications Act of 1996 and the competitive environment it was designed to create. But the "reverse triage" approach contemplated in the *Notice* that would reduce reciprocal compensation to new entrants while leaving bloated access charges in place would indefinitely preserve the most objectionable aspects of the existing patchwork and, in the process, increase the incumbent LECs' already formidable competitive advantages. The Commission should instead establish a uniform intercarrier compensation rule in which "a minute is a minute" for transport and termination purposes, regardless of its content, the means of switching in transit, or the identity of either the called party or the carrier. Congress intended precisely that result when it gave the Commission authority in 47 U.S.C. § 251(g) to establish a reasonable transition period before bringing access charges within the cost-based reciprocal compensation standard that Congress mandated will ultimately apply to the transport and termination of ***all*** "telecommunications." *See* 47 U.S.C. § 251(b)(5).

The single approach that should be applied uniformly is the forward-looking, cost-based intercarrier compensation mandated by the Act and fundamental economic principles. As the Commission has long recognized, properly structured forward-looking, cost-based prices encourage efficient investment and use, discourage regulatory arbitrage, and create a level, competitively neutral playing field. Properly cost-based intercarrier compensation for transport and termination would also fully address the regulatory arbitrage, monopoly abuse and other "pressing issues" identified in the *Notice* (¶¶ 11-18). Indeed, when rates are set on the basis of forward-looking costs, a carrier should (absent anticompetitive motives) be indifferent whether it terminates traffic itself or compensates another carrier for providing this service.

The *Notice* instead proposes a radical departure from the existing calling party's network pays regime ("CPNP") to a new "bill and keep" rule ("B&K"), in which the terminating carrier would be required to recover termination costs from the called party. A B&K rule would be neither efficient nor competitively neutral and would open a Pandora's box of unintended and undesirable consequences.

B&K would not promote more efficient network usage by consumers. To the contrary, B&K would encourage more unwanted calls (by effectively requiring recipients to pay for terminating the unwanted calls) while weakening the ability that consumers currently enjoy to share the costs of mutually beneficial telephone calls in rough proportion to the relative benefits enjoyed by the calling and called parties, *e.g.*, by alternating which party calls the other.

Nor is B&K more "deregulatory" than cost-based intercarrier compensation. Under B&K, costs that are now recovered from carriers would instead be recovered from end users. Because incumbent LECs will retain market power over consumers for the foreseeable future, these new end user charges would have to be regulated if B&K were adopted. In fact, as the *Notice* recognizes (¶ 62), a B&K approach could create whole new categories of regulatory burdens and disputes.

At the same time, B&K would create ***new*** opportunities for both regulatory arbitrage and monopoly abuse. As the Commission has previously recognized, a B&K regime, in which the originating network paid none of the costs of terminating calls made by its customers, would foster a whole new form of regulatory arbitrage by encouraging carriers to seek out customers that make more calls than they receive. A B&K rule would likewise make originating LECs responsible for sizing and charging customers for the links between the LECs' networks and IXCs' points of presence, thereby creating dangerous new opportunities for incumbent LECs with long distance authority to favor their long distance affiliates.

The ***Notice*** also seeks comment on the efficiency of several specific interconnection rules and practices. These questions are largely independent of the choice between cost-based CPNP and B&K, and, in each case, the existing rule or practice better promotes efficiency and competitive neutrality than would available alternatives. Thus, the Commission should retain the existing rule that a competitive carrier may choose the technically feasible point or points at which its network will interconnect with an incumbent's network. ***See*** 47 C.F.R. § 51.305. The widespread practice of both competitive and incumbent carriers of assigning "NPA-NXX" codes associated with a local calling area to customers located outside that local calling area ("virtual central office codes") is likewise efficient, and incumbent LECs should not be allowed to impose access or other charges on this traffic. The same is true of indirect interconnection, ***see*** 47 U.S.C. § 251(a), in which an incumbent LEC is compensated to deliver "transiting" traffic over its ubiquitous network from an originating carrier that serves the calling party to the terminating carrier that serves the called party. The Commission should also reaffirm the existing rule that a competitive carrier may charge higher "tandem" switching rates when it terminates calls from a switch in its efficient, single-layer switching architecture that serves a geographic area comparable to a tandem switch in the incumbent's legacy two-layer switching architecture.

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Washington, D.C. 20554

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COMMENTS OF AT&T CORP.

Pursuant to Rule 1.415, 47 C.F.R. § 1.415, AT&T Corp. ("AT&T") submits these comments regarding intercarrier compensation reform in response to the Commission's April 27, 2001 Notice of Proposed Rulemaking in the above-captioned proceeding ("*Notice*").[1]

INTRODUCTION

AT&T supports the Commission's goal of reforming and unifying legacy intercarrier compensation regulations. The existing patchwork of rules – under which a local exchange carrier's charges for use of the same facilities in the same manner can vary by an order of magnitude or more based upon such economically irrelevant considerations as the identity or status of the interconnecting carrier or the called party – is wholly incompatible with the competitive environment Congress envisioned. Inappropriate intercarrier charges create barriers to entry, tilt the competitive playing field, and distort investment and use. And five years after passage of the Act, with the competitive LEC industry on the verge of collapse and the all-too-real threat of Bell Operating Company ("BOC") remonopolization, it is more important than ever that the Commission ensure that incumbent LECs cannot leverage uneconomic intercarrier charges to maintain and extend their dominance.

[1] *See In the Matter of Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, CC Docket No. 01-92, FCC 01-132 (April 27, 2001).

The *Notice* begins by asking the right question: what are the proper goals of intercarrier compensation regulation. As explained below and in the attached declaration of economists Janusz A. Ordover and Robert D. Willig ("*Ordover-Willig*"), the answer is the same one that the Commission has repeatedly endorsed in recent years as the guide for regulating intercarrier payments: such regulation should implement the twin goals of efficiency (in investment and use) and competitive neutrality.

The *Notice* also properly recognizes that the compensation rule that best promotes those goals will generally be uniform, regardless of the legacy labels associated with the carriers or traffic involved and that the arbitrary differences in regulatory treatment that have been tolerated in the past have become increasingly intolerable in rapidly converging communications markets. In today's environment, intercarrier compensation rules that favor one class of carriers over others are among the most serious threats to efficient competition. For that reason, singling out only one compensation regime for reform, while leaving other flawed legacy regimes in place, is more likely to undermine, rather than promote, efficiency and competitive neutrality.

But the *Notice* proposes to do exactly that, by continuing arbitrary and non-economic differences through different "transition" periods for the various legacy regimes. Even more unfortunately, the *Notice* contemplates an approach that would largely ignore the areas in which reform is most needed and would focus instead on the areas in which reform is least needed. An inevitable result of this "reverse triage" would be to tip the competitive scales even further in favor of the incumbent LECs. Thus, although reductions are already underway for the intercarrier charges of which the incumbents have complained,[2] the Commission "do[es] not

[2] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Intercarrier Compensation for ISP-Bound Traffic*, CC Docket No. 96-98, Order on Remand, FCC 01-131 (April 27, 2001) *("ISP Remand Order")*.

anticipate implementing major changes to [the] access charge rules in the initial phase of this proceeding." *Notice* ¶ 97. Rather, the Commission-sponsored "transition" to cost-based access charges that has already spanned nearly two decades would continue indefinitely. *Id.* The cost-based compensation that incumbent LECs pay to other carriers would quickly be zeroed out, while compensation that incumbents receive from those same carriers would not only continue, but continue massively to exceed the relevant costs. There is little to be gained from "[t]he long term goal of this *NPRM* . . . to develop a uniform regime for all forms of intercarrier compensation, including interstate access," *id*, if the only carriers that remain in that "long term" are the incumbent LECs. The Commission must therefore take great care to ensure that the reforms taken in this proceeding actually produce a unified approach that both recognizes that the costs associated with delivering traffic do not turn on the identity of the originating or terminating carrier or of the calling or called party, and that is implemented in a competitively neutral fashion that does not have the effect of picking winners and losers.

The guiding principle for a unified approach to intercarrier compensation should be clear. **As** the Commission has long recognized, efficiency and competitive neutrality are fostered by intercarrier compensation that is based upon forward-looking costs. Properly structured forward-looking, cost-based prices encourage efficient investment and use, discourage regulatory arbitrage, and create a level, competitively neutral playing field.[3] It is therefore unsurprising that the current environment, in which intercarrier charges are not consistently based upon economic costs, is characterized by regulatory arbitrage, monopoly abuse and the other "pressing issues" the Commission has identified. *See Notice* ¶¶ 11-18.

[3] *See generally In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd. 15499, ¶¶ 672-703 (1996) ("*Local Competition Order*").

The *Notice* suggests that these problems can be addressed only by abandoning the longstanding CPNP convention, pursuant to which the carrier that serves the calling party pays the called party's network for delivering the call, in favor of a new B&K rule, in which the terminating carrier would be required to recover its costs of delivering a call from the called party. But it is the failure consistently to implement forward-looking cost-based pricing, and ***nut*** the CPNP convention, that facilitates regulatory arbitrage, the abuse of terminating access monopolies, and the other ills that the *Notice* identifies. Properly set charges – that is, charges that reflect forward-loolung, economic costs – provide no windfall and thus no opportunities for regulatory arbitrage or the imposition of unreasonably high charges. No radical departure from the CPNP rule is needed to foster efficiency and competitive neutrality; rather, all that is missing is a commitment to enforce forward-looking cost-based pricing.

As an initial matter, intrastate access charges are a very substantial portion of total intercarrier compensation payments, and it would therefore be impossible to achieve a unified B&K approach to intercarrier compensation unless and until the states also agreed to abandon CPNP. Proceeding with an interstate B&K rule, notwithstanding state adherence to CPNP, on the other hand, would create enormous incentives and opportunities for regulatory arbitrage.

And it is unlikely that the Commission could ever get the states to agree to uniform adoption of B&K because that rule is neither efficient nor competitively neutral and would open a Pandora's box of unintended and undesirable consequences. B&K is clearly inferior to cost-based CPNP as a matter of economic theory. Under the existing CPNP regime, the calling party is ultimately responsible for the charges that she "causes," *i.e.*, the costs associated with terminating the call that she initiates. As the Commission has repeatedly held, efficiency is generally promoted by such a "cost causation" rule. The *Notice* points out that the called party often also benefits from a telephone call and suggests that this positive "externality" may justify a departure from cost causation. As Professors Ordover and Willig explain, however, the far more important externality in this context is the ***negative*** externality associated with unwanted calls. And CPNP both minimizes that negative externality by forcing telemarketers to bear all of the direct costs of their calls and is sufficiently flexible to allow the called and calling parties to internalize the positive externality (by, for example, taking turns calling each other and adjusting the length of time that they talk when one party calls the other). A B&K rule, in contrast, would not only encourage more unwanted calls (by effectively allowing telemarketers to terminate their calls for free), it would force the unfortunate recipients of such calls to pay for the "pleasure" of receiving dinner and family time interruptions from cranks and hawkers of credit cards, funeral plots, time share condominiums, vinyl siding, penny stocks and burglar alarms.

Such a clear departure from basic economic principles cannot be papered over with claims that B&K would be more "deregulatory." B&K would reduce the absolute number of intercarrier charges for which forward-looking costs must be estimated. But that is of no real moment, because the same costs would still have to be estimated to set unbundled network element charges for the equivalent switching and transport functionalities. Moreover, B&K would simply mean that costs that have always been recovered from carriers would now be recovered from consumers, And because incumbent LECs will retain substantial local market power for the foreseeable future, these new end user charges would have to be regulated, both to protect consumers from unreasonably high charges and to protect competition from discriminatory end user charges designed to discourage consumers from purchasing services from the incumbent LECs' competitors. Thus, any "deregulatory" virtues of a B&K rule are entirely illusory. Indeed, as the *Notice* recognizes, a B&K approach could create whole new categories of regulatory burdens and disputes. *See Notice* ¶¶ 58-62.

And the *Notice* fails entirely to recognize the fundamental changes in virtually every aspect of retail telecommunications pricing that would follow a switch to B&K. Consumers would pay for the *receipt* of telephone calls, including unwanted calls. Consumers would have to add up separate rate elements from the originating LEC, the IXC and the terminating LEC to determine the price of long distance calls – and those LEC charges could vary from one call to the next call. The prices of Internet service would almost surely rise and become increasingly usage-based. Even aside from the high political price that would necessarily accompany those "reforms," such radical change would almost certainly have additional, unforeseeable consequences. At a minimum, then, the Commission should demand proof of substantial efficiency gains before embracing any B&K rule.

There would be no such gains. In fact, as detailed below and in the Ordover-Willig Declaration, a properly administered cost-based CPNP regime is far more flexible and likely to produce efficient outcomes and network usage than a B&K rule. As the Commission has long recognized, B&K simply cannot make economic sense, even as a matter of theory, unless traffic is in balance. But traffic is necessarily out of balance in the context of interexchange access and often so in other contexts.

A B&K rule would be a particularly inappropriate response to the regulatory arbitrage and monopoly abuse concerns that are the focus of the *Notice* because it would create *new* opportunities for both regulatory arbitrage and monopoly abuse. As the Commission previously recognized in rejecting similar B&K proposals, a B&K regime, in which the originating network paid none of the costs of terminating calls made by its customers would, for example, foster a whole new form of regulatory arbitrage by encouraging carriers to seek out customers that make more calls than they receive (*e.g.*, telemarketers, stock brokers). *Local Competition Order* ¶ 1112.

A B&K rule would likewise make originating LECs responsible for sizing and charging customers for the links between the LECs' networks and IXCs' points of presence, thereby creating dangerous new opportunities for incumbent LECs with long distance authority to favor their long distance affiliates by providing inadequate transport links to long distance competitors. B&K would tilt the playing field further in favor of incumbent LECs with respect to local service as well, by ending cost-based reciprocal compensation, the one existing constraint on incumbent LECs' incentives to inflate massively the costs of UNE transport and switching. In short, there is nothing to be gained and much to be lost by abandoning the CPNP rule – the one uniform aspect of the existing intercarrier compensation patchwork – in favor of "COBAK,"[4] "BASICS,"[5] or any other B&K proposal.

The conclusion that intercarrier compensation reform should focus on a commitment to cost-based pricing, and not a radical new B&K rule, is further confirmed upon specific consideration of each of the relevant contexts in which traffic is exchanged between carriers. Sections 251(b)(5) and 252(d)(2) of the Act, which govern reciprocal Compensation for the transport and termination of "telecommunications," flatly forbid any B&K rule that would apply regardless of whether carriers' traffic is in balance. In particular, Section 252(d)(2) expressly mandates that reciprocal compensation must afford recovery of the terminating

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[4] *See* Patrick DeGraba, *Bill and Keep at the Central Office as the Efficient Interconnection Regime*, OPP Working Paper Series, No. 33 (December 2000) *("DeGraba").*

[5] *See* Jay M. Atkinson and Christopher *C.* Barkenov, *A Competitively Neutral Approach to Network Interconnection,* OPP Working Paper Series, No. **34** (December 2000) ("*Atkinson-*
(continued . . .)

carrier's costs – which the Commission has recognized B&K cannot do when traffic is significantly out of balance. *Local* ***Competition Order*** ¶ 1112.

The Commission's existing rules for intercarrier compensation for traffic subject to Section 251(b)(5) – which require cost-based, symmetrical compensation from the calling party's network to the called party's network and properly allow the rate structure to reflect the manner in which costs are incurred (*e.g.*, traffic-sensitive vs. non-traffic-sensitive) – are well-tested and workable and should serve as a model for a unified approach to intercarrier compensation. The problems that the *Notice* identifies with the current regime, and, in particular, the current regime as applied to ISP-bound traffic, have nothing to do with the choice between CPNP and B&K and everything to do with the fact that some reciprocal compensation rates have been set too high. Where that has happened, rates have been set too high for *all* traffic, because, as the Commission has recognized, it is not systematically less costly to terminate ISP-bound traffic than other traffic. And any such problem is easily solved simply by strict application of the existing requirement of cost-based prices.

The same rule can and should govern interexchange access charges. It is critically important that the Commission establish a uniform intercarrier compensation rule in which "a minute is a minute" for transport and termination purposes, whether it is a voice or data minute, whether the called party is an ISP or a pizza parlor, whether the call is jurisdictionally interstate or intrastate, and whether the carriers involved are LECs or IXCs. Congress intended precisely that result when it gave the Commission authority in Section 251(g) to establish a reasonable transition period before bringing access charges within the cost-based Section 251(b)(5)

(. . . continued)
Barkenov").

reciprocal compensation standard that Congress mandated will ultimately apply to the transport and termination of all "telecommunications." And even apart from the reasons why B&K is inferior to CPNP as a general matter, it would be unworkable in the access charge context. Consumers should not have to add up charges across multiple carriers to determine the price of a long distance call, but a B&K rule would result in individual charges across three carriers (the originating and terminating LECs and the IXC), increasing customer confusion – and, as noted above, the opportunities for incumbent LECs to abuse their monopolies to favor their own long distance services.

In sum, a B&K approach to intercarrier compensation would not advance the public interest. Reform is required, but the public interest will be served by reforming and unifying the patchwork of legacy intercarrier compensation rules in the manner that both economics and the statute dictate: forward-looking, cost-based intercarrier compensation.

The *Notice* also seeks comment on the efficiency of several specific interconnection rules and practices. These questions are largely independent of the choice between CPNP and B&K, and, in each case, the existing rule or practice better promotes efficiency and competitive neutrality than would available alternatives.

Thus, the Commission should retain the existing rule that a competitive carrier may choose the technically feasible point or points at which its network will interconnect with an incumbent's network. *See* **47** C.F.R. § 51.305. That rule is required by the plain language of Section 251(c)(2)(B), which obligates an incumbent LEC to permit interconnection "at any feasible point" within the incumbent's network. In all events, the existing rule – together with the corresponding rule that an originating carrier must both bear all costs on its side of the chosen point of interconnection and reimburse the terminating carrier for the forward-looking costs of transporting the call from that point of interconnection – properly balances requiring the competitive carrier to bear the costs of its interconnection choices with ensuring that the incumbent LEC's legacy network design and scale economies are not exploited to impede competition.

The widespread practice of both competitive and incumbent carriers of assigning "NXX" codes associated with a local calling area to customers located outside that local calling area ("virtual central office codes") is likewise efficient, and incumbent LECs should not be allowed to impose access or other charges on this traffic. The same is true of indirect interconnection, see 47 U.S.C. § 251(a), in which an incumbent LEC is compensated to deliver "transiting" traffic over its ubiquitous network from an originating carrier that serves the calling party to the terminating carrier that serves the called party. **As** Professors Ordover and Willig explain, both practices appropriately tie charges to forward-looking costs and allow new entrants to share in the incumbents' scale economies.

Finally, the Commission should reaffirm the existing rule that a competitive carrier may charge higher "tandem" switching rates when it terminates calls from a switch in its efficient, single-layer switching architecture that serves a geographic area comparable to a tandem switch in the incumbent's legacy two-layer switching architecture. **As** Professors Ordover and Willig explain, so long as incumbent LECs are, by virtue of the Commission's "scorched node" assumption, see 47 C.F.R. § 51.505(b)(1), allowed to charge tandem rates to terminate traffic that could be terminated at less cost in a more efficient single-layer architecture, competitive neutrality requires that competitive carriers be allowed to charge the same tandem rate.

The remainder of AT&T's comments are organized as follows. In Part I, AT&T demonstrates that the regulatory arbitrage, monopoly abuse and other problems identified in the ***Notice*** are symptoms not of the CPNP convention, but of the failure consistently to require forward-looking cost-based prices, and that a properly cost-based CPNP rule for the transport and termination of telecommunications would be efficient and competitively neutral. Part II proves that B&K is neither superior, as a matter of economic theory, nor more "deregulatory" than cost-based compensation under the existing CPNP convention. Part III demonstrates that B&K would have serious unintended consequences, fostering new forms of regulatory arbitrage and monopoly abuse and causing confusing changes in retail telecommunications pricing. Part IV explains that application of a B&K rule to the transport and termination of telecommunications subject to Section 251(b)(5) would be both unlawful and inefficient. Part V details why B&K would be particularly unworkable in the interstate access context and details the reforms needed. Part VI explains why the Commission should not extend the current access charge regime to IXC-CMRS interconnection. And Part VII demonstrates that the existing interconnection rules and practices on which the Commission seeks comment are efficient and should be preserved.

ARGUMENT

There can be no serious dispute that there is an urgent need for reform of the current patchwork of conflicting intercarrier compensation rules. A LEC uses the same facilities in the same way and at the same cost to transport and terminate telephone calls originated on another network, regardless of the identities of the other carrier or either of the parties to the call. Yet, under legacy intercarrier compensation rules, these irrelevant characteristics of the identity of the originating carrier and the parties to the call determine how much the LEC will charge to transport and terminate the call. ***See Notice*** ¶ 5 (existing rules "treat different types of carriers and different types of services disparately, even though there may be no significant differences in the costs among carriers or services"). The absolute rate differences are enormous – a LEC may charge an IXC ten times more than it charges another LEC to provide what is, in reality, the very same transport and termination service – and they cause massive economic distortions at enormous public expense.

Congress recognized the need for a single, unified intercarrier compensation rule when it directed LECs in 1996 to establish just and reasonable reciprocal compensation arrangements for all "telecommunications." 47 U.S.C. § 251(b)(5). And Congress likewise recognized that cost-based intercarrier charges send appropriate economic signals. *Id.* § 252(d)(2). The ***Notice*** (¶ 4), however, tentatively concludes that current marketplace distortions that can all be traced directly to past failures to consistently require cost-based intercarrier charges can only be addressed by abandoning intercarrier charges altogether through a B&K rule that would substitute end-user charges. **As** demonstrated below, that tentative conclusion is misguided and would, if implemented, do great harm to consumers and competition.

B&K would solve no existing problem that could not be solved as or more effectively under the existing CPNP convention, and B&K would neither lead to more efficient network usage nor obviate the need for rate regulation. And, as detailed below, any switch to B&K would have many unintended and highly undesirable consequences.

I. EACH OF THE ISSUES IDENTIFIED IN THE *NOTICE* CAN AND SHOULD BE FULLY ADDRESSED WITH COST-BASED COMPENSATION UNDER A CPNP CONVENTION.

The Commission identifies the motivating force behind the *Notice* as a set of "pressing issues" that have arisen under the "existing intercarrier compensation rules." *Notice* ¶ 11. Two recent papers prepared by the Commission's staff argue that abandonment of the well-established CPNP system in favor of a "unified" B&K system would address these problems, and the Commission seeks comment on the feasibility and desirability of an across-the-board B&K approach. *Id.* ¶¶ 1, 22.

None of the issues identified in the *Notice* turns on whether the unified rule of intercarrier compensation is CPNP or B&K. Rather, all of these problems are attributable to "the failure to require forward-looking, economic cost-based prices," and each can and should be fully addressed within the existing CPNP system. *Ordover-Willig* ¶ *32.*

The Commission identifies five significant issues in the *Notice:* (1) regulatory arbitrage; (2) terminating access monopolies; (3) differing costs for different types of networks; (4) inefficient rate structures, such as charging traffic-sensitive rates to recover non-traffic-sensitive costs; and *(5)* incentives for end users to claim to be carriers. *Notice* ¶¶ 11-18. In fact, all of these problems, to the extent that they exist at all, are the direct result of intercarrier rates that depart from economic cost. Absent a strong commitment to cost-based transport and termination charges, the problems that the Commission has identified will persist in one form or another whether the Commission retains CPNP – as it should – or adopts B&K.

Regulatory Arbitrage. The Commission identifies two phenomena under the existing system that it labels "regulatory arbitrage." *Notice* ¶¶ 11-12. First, the Commission argues that the rates for reciprocal compensation may be "inefficiently structured or set too high" in ways that have created inefficient incentives for new entrants to target customers with predominantly terminating traffic. ***Id.*** **¶ 11**. Second, the *Notice* (¶ 12) contends that the ESP exemption gives providers of IP telephony an "artificial cost advantage" over interexchange carriers.

Neither of these "arbitrage" issues has anything to do with CPNP or B&K as systems of intercarrier compensation. Rather, to the extent that regulatory arbitrage opportunities exist today, they are the direct result of rates that stray significantly from economic costs. **As** Professors Ordover and Willig observe, when intercarrier charges reflect forward-looking economic costs, there is, "by definition, . . . no inefficient incentive to serve customers just for the purpose of receiving traffic and earning compensation."[6] Likewise, when termination rates are properly set on the basis of forward-looking costs, a carrier is indifferent to whether it terminates its own traffic or another carrier provides that service. *Ordover-Willig* **¶ 41.** Thus, any regulatory arbitrage problems can and should be addressed directly by using TELRIC principles to establish the rates for compensation for terminating traffic. Simply switching from CPNP to a B&K rule, in contrast, could not possibly remove opportunities for regulatory arbitrage; rather, that would occur only if the termination charges applicable under that rule – end user termination charges – were appropriately capped. *See Ordover-Willig* **¶ 43**

As the Commission has explained in the access context:

> [U]neconomic bypass may occur for a variety of reasons; rates may be too high, or our access charge rules may require rates for a LEC access service to be too high in relation to the rates for an alternative LEC service or for a comparable

[6] *Ordover-Willig* ¶ **43** ("forward-looking cost-based rates allow a carrier to recover only the efficient costs of termination (including a normal return on deployed terminating assets) and therefore create no opportunities for regulatory arbitrage"); *Local Competition Order* ¶ 699 (TELRIC-based rates ensure that carriers receive only "normal" profits and not "economic," or supracompetitive, profits).

> service offered by an alternative supplier. Inefficient entry may occur if the price for a package of jointly-provided services is above economic cost, even if the LEC would actually be the most efficient provider of the service. Conversely, if a package of jointly-provided services, including access, is priced too low because of regulatory requirements, efficient entry by an otherwise efficient provider may be precluded. In either case, the total cost of telecommunications service will not be as low as it could be if all services were priced at economic levels, thereby providing accurate price signals to all market participants.

In the Matter of Access Charge Reform, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 11 FCC Rcd. 21354, ¶ 42 (1996) ("*Access Charge NPRM*"). This analysis is correct. Only proper pricing, applied consistently and without unusual exceptions, can discourage regulatory arbitrage. *Ordover-Willig* ¶ 42.

The *Notice* (¶ 11) identifies ISP-bound traffic as one kind of traffic that is particularly susceptible to arbitrage, but both the *Notice* and the Commission's previous findings belie the notion that any such arbitrage is attributable to the CPNP convention. As the *Notice* itself states, if new entrants are *unduly* targeting end-users (like ISPs) that have predominantly terminating traffic – and the *Notice* presents no evidence that this is the case – it is because the rates for reciprocal compensation are either "inefficiently structured or set too high." *Id*. The solution is obvious: require properly structured, cost-based rates.[7] Certainly, incumbent LECs could have no legitimate complaint about cost-based reciprocal compensation rates. Indeed, leaving aside for a moment any anticompetitive motives, an incumbent LEC should be indifferent whether it terminates a call itself or pays TELRIC-based reciprocal compensation to another terminating carrier.

Equally important, as the Commission has expressly found, there are no inherent cost differences in terminating traffic to ISPs as compared to other end-users and thus no reason

[7] *Ordover-Willig* ¶ 45 ("there would be no such incentive [to engage in arbitrage] if the reciprocal compensation rates were properly based on the forward-looking, economic costs").

to single out ISP-bound traffic for special treatment.' To the contrary, the Commission should simply insist on compliance with its existing reciprocal compensation rules, which already require that rates be properly structured and based upon forward-looking costs. And to the extent that particular individual carriers are engaging in abusive behavior, the proper solution is to discourage the unreasonable practices of those carriers.

The Commission also notes the possibility of regulatory arbitrage via IP telephony. ***See Notice*** ¶ 12. Even if significant regulatory arbitrage were associated with IP telephony, the blame for any such arbitrage could not be placed on CPNP. Rather, arbitrage opportunities result from other regulations, including Commission decisions to set access charges well above costs and, recognizing the devastating anticompetitive impact that bloated access charges could have on new technologies and emerging services, to exempt enhanced service providers ("ESPs") from paying those charges (the "ESP exemption"). ***See*** DeGraba ¶ 78. And the simple solution to prevent regulatory arbitrage via IP telephony from ever becoming a pressing issue is to ensure that access charges are reduced across-the-board to forward-looking costs. In light of the extent to which the industry has developed with the ESP exemption, eliminating the ESP exemption and subjecting ESPs to bloated access charges would cause great harm – further depressing already weakened new technology and emerging services markets, and removing the much-needed pressure that the ESP exemption properly exerts to speed the transition to forward-looking cost-based access charges. **As** a more general matter, the

[8] ***See*** *ISP* ***Remand Order*** ¶ 90 ("we see no reason to impose different rates for ISP-bound and voice traffic. The record developed in response to the ***Intercarrier Compensation NPRM*** and the ***Public Notice*** fails to establish any inherent differences between the costs on any one network of delivering a voice call to a local end-user and a data call to an ISP"); ***see also id*** ¶ 90 n.180 ("Many commenters argue that there is, in fact, no difference between the cost and network functions involved in terminating ISP-bound calls and the cost and functions involved in terminating other calls to users of the public switched telephone network").

Commission should be skeptical of those seeking to close what they term "loopholes" to paying monopolistic rates. Experience with international settlement rates, for example, has shown that preserving marketplace alternatives is sometimes the only way of creating an environment in which monopolists will curtail their efforts to thwart or delay a more rational rate structure.

Terminating Access Monopolies. The *Notice* (¶¶ 13-15) rightly expresses concern over the abuse of terminating access monopolies by both incumbent LECs and competitive LECs. These monopoly abuses can, and should, be fully addressed, however, within the context of CPNP by establishing cost-based rates for terminating access services that bring the added benefit of consistency with cost causation principles. Moreover, at least with respect to incumbent LECs, these terminating access monopolies exist – and will continue to exist – independent of the CPNP/B&K choice.[9] That is because incumbent LECs will for the foreseeable future continue to retain substantial local market power over both end users and other carriers. Thus, absent regulation, these LECs could abuse their monopolies whether or not they were required to charge other carriers or end users for termination. *See Ordover-Willig* ¶ 54 ("incumbent LECs retain substantial market power, and thus, all that B&K would do is change the entity that must be protected from LEC market power"). In other words, limiting carriers' ability to abuse their market power as to other carriers would do nothing to alter their ability ultimately to abuse that market power as to end users.

[9] *See, e.g.*, *In the Matter of Access Charge Reform,* Seventh Report and Order, FCC 01-146, ¶¶ 30-31 (April 27, 2001) ("*CLEC Access Order*") ("once an end user decides to take service from a particular LEC, that LEC controls an essential component of the system that provides interexchange calls, and it becomes the bottleneck for IXCs wishing to complete calls to, or carry calls from, that end user"); *Access Reform NPRM* ¶ 279 ("The factors that warrant continued regulation of incumbent LECs' terminating access service appear to apply to *all* access providers, including competitive LECs, because these new entrants appear to possess market power over IXCs needing to terminate calls.") (emphasis added).

Similarly, the Commission can and should prevent price squeezes under the CPNP system. *See Notice* ¶ **15.** "It is the *above-cost* access rates that give the LECs the potential to implement an anticompetitive price squeeze. That is because the incumbent LECs with long distance authority can obtain access (from themselves) at economic cost, but charge their IXC competitors rates that are well above costs." *Ordover-Willig* ¶ 55. Indeed, as the Commission noted in the *Local Competition Order,* one significant advantage of adopting a pricing regime such as TELRIC that relies on forward-looking, economic costs is that it helps to avoid the risk of price squeezes.[10]

Different Networks/Different Rates. The fact that different networks might have different costs *(see Notice* ¶ **16)** is not a reason to depart from forward-looking, cost-based pricing, which, by its very nature, is based upon the *economic* costs of transport and termination, and not upon the expenditures of any particular carrier or class of carriers or upon the particular choices of called parties as to how and with what features they wish to receive calls. Moreover, to the extent that there are relevant cost differences between different networks, cost-based pricing is fully capable of accounting for those differences.

Inefficient Carrier Rates. The Commission also rightly expresses concern about inefficient carrier rates *(see Notice* ¶¶ 17-1**8),** but once again those concerns provide compelling reasons, not to abandon CPNP, but to establish fully cost-based and cost-causative rates. And to the extent existing intercarrier rates are billed on a traffic-sensitive basis where costs are non-traffic-sensitive, *see Notice* ¶ 60, that is only a matter of proper rate design, *see Ordover-Willig* ¶ 61, that could not be avoided by switching to a B&K rule. In fact, B&K would raise the same

[10] *See Local Competition Order* ¶ **63**5